



U.S. SENATE REPUBLICAN POLICY COMMITTEE

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Cramdown—A Harmful Policy for the Troubled Housing Market

Executive Summary

- Cramdown is commonly referred to as authorizing bankruptcy judges to impose a reduction in the mortgage principal for primary residences.
- The Obama Administration's new housing proposal would impose cramdown under certain circumstances.
- There are real costs for American consumers if cramdown is imposed upon lenders, including credit unions.
- The process will lead to higher interest rates on future mortgages and other loans.
- Cramdown has the ability to further weaken U.S. financial institutions.
- Taxpayers are also at risk for huge financial losses from cramdown.
- Allowing cramdown undermines the willingness of homeowners to participate in the loan modification process.

Background

The U.S. economy continues to experience significant difficulties not seen in many decades. From rising unemployment to the falling Gross Domestic Product (GDP), the American economy is in a period of dramatic contraction. This includes a significant reduction in outstanding credit held by U.S. industry and consumers (i.e., deleveraging) as well as reduced access to new credit.

A major reason for the current troubled economy is the downturn occurring in the once overheated housing market. As the market reverses its prior gains, homeowners are experiencing dropping home prices, tougher scrutiny for new home loans and refinances, unprecedented unsold home inventories, and the resetting of certain mortgage rates. An additional result is that

many homeowners are unable to pay their current mortgages or are left with negative equity in their homes.

Numerous mitigation programs have been created to reduce homeowners' monthly mortgage payments, and consequently avoid foreclosures, in order to deal with the difficult economic times. Many lenders have voluntarily agreed to rework existing mortgages and the federal government has created differing programs, in cooperation with lenders, to aid homeowners. Notwithstanding this work and the reality that many borderline foreclosure homeowners cannot be saved under any circumstances, Democrats have sought to go one additional step: to allow bankruptcy judges to essentially erase mortgage principal that is above the current market price for the primary residence of a homeowner—commonly referred to as a “cramdown” for primary residences. While the cramdown debate centers on housing, it ultimately requires changes to the bankruptcy process.

Bankruptcy

Individuals unable to repay their debts have three main bankruptcy options: Chapters 7, 11, and 13. While Chapter 7 focuses on the discharge of debt through liquidation, Chapters 11 and 13 are intended to facilitate debt restructuring. Data suggests that for individuals Chapter 7 is used roughly two-thirds of the time, Chapter 11 less than 1 percent, and Chapter 13 one-third.

Chapter 13 requires a reorganization plan be developed and submitted to the bankruptcy court for dealing with existing debts. The plan establishes a time period (over 3 to 5 years) to repay all or part of the debt, and prevents creditors from starting or continuing collection efforts. It also classifies debt as priority (e.g., taxes and bankruptcy costs), secured (i.e., creditor has the right to reclaim the collateral), or unsecured. At the end of reorganization plan, any remaining unsecured debt is dismissed.

Under Chapter 13, the reorganization plan may modify the rights of holders of secured debt. In particular, the law allows for the modification of the length, interest rate or principal of the balance of a secured loan. That is, the court has the authority to lower the principal owed for secured claims to its fair market value; any excess above that amount is split off and treated as unsecured debt. This provision, however, does not extend to first liens (i.e., first mortgages) on primary residences. Section 1322(b)(3) of Chapter 13 of the Bankruptcy Code explicitly prohibits a modification for “a claim secured only by a security interest in real property that is the debtor’s primary residence.”

Critics argue that the primary residence exception is a glaring error in Chapter 13. It is important to note that while other secured assets (e.g., second homes, boats) are subjected to cramdown under current law, in those cases the entire loan amount is due by the end of the reorganization plan (i.e., 3 to 5 years). Thus, there is a real difference between existing cramdown provisions and the additional changes sought as they pertain to primary residences.

Administration’s Housing Proposal

On February 18, 2009, U.S. Treasury Secretary Timothy Geithner released details on the Administration’s Housing Affordability and Stability Plan. While the plan includes a home

mortgage refinancing program and an additional \$200 billion for two government-sponsored entities—Fannie Mae and Freddie Mac—the central component is a new \$75 billion subsidy program in an attempt to spur successful home loan modifications. By providing incentives and using its considerable leverage, the Treasury Department hopes to lower the number of housing foreclosures by 3 to 4 million through loan modifications.

Not all homeowners will qualify for the loan modification program. Subject to guidelines released on March 4, 2009, and additional rules to be completed soon by the Treasury Department, those homeowners who actively pursue a loan modification with their lender but are rejected would be permitted to enter bankruptcy court protection with added benefits. In other words, as a last resort for homeowners, authority would be provided to the corresponding bankruptcy judge to utilize cramdown as a means to restructure mortgage principal for primary residences.

Recent Senate Action

The Senate last considered cramdown in April 2008 as part of the ultimately-passed Housing and Economic Recovery Act of 2008, which used the renewable energy bill as a legislative vehicle. The amendment was not included in the final bill. Specifically, the Senate voted 58 to 36 to table Senator Durbin's amendment (S.A. 4388) to impose cramdown, among other things.

Current House Efforts

Last week, the House of Representatives passed H.R. 1106, the Helping Families Save Their Homes Act of 2009, by a vote of 234 to 191. The bill consists of two central components: (1) reforms to housing law; and (2) changes to the bankruptcy code, including provisions to enact and impose cramdown.

Reasons to Oppose

There are real costs for American consumers if cramdown is imposed upon lenders. By necessity, lenders will need to account for the added risk and loss of potential future revenue caused by this change in lending practices. This ultimately means that new mortgage loan applicants will see higher interest rates, higher down payments, and higher fees for borrowing. In turn, it will lower the number of homes that will be sold as certain families are unable to obtain mortgages, and since unsold home inventories are already bloated, it will exert downward pressure on home prices.

Cramdown has the ability to further weaken U.S. financial institutions (for this purpose the term should be interpreted broadly to cover all types of firms, including all banks, credit unions, and investment firms). At a time when hundreds of billions of American taxpayer funds are being funneled into the banking and commercial lending sector, cramdown would counter this by lowering revenues for these institutions and thus increasing their capital needs. In addition, the securitization market, which has been equally decimated over the last year, cannot improve as banks originate fewer mortgages and as investors remain on the sidelines unwilling to invest in securities in which the value of the asset(s) can be changed without lender approval.

Taxpayers are also at risk for huge financial losses from cramdown. Surprisingly, many Americans are unaware that they are indirect holders of mortgages and mortgage-backed securities through their financial investments and retirement accounts. Lost revenue that results from bankruptcy cramdown means reduced returns and less financial wealth. In addition, considering that the federal government—i.e., taxpayers—is responsible for the financial status of Fannie Mae and Freddie Mac, losses imposed by cramdown on mortgages held or guaranteed by these entities means greater losses in federal revenues.

Moreover, cramdown has an inverse relationship with loan modifications. At a time when lenders and the federal government have been trying to work with homeowners to voluntarily restructure mortgage payments, cramdown unfairly tilts the playing field towards bankruptcy. Specifically, it provides homeowners with an opportunity to eliminate mortgage principal that is unlikely to be done under loan modifications. Even allowing cramdown as a last resort provides a real incentive for homeowners to dismiss loan modifications offers, not adequately participate in the process, or default with the hopes of using cramdown later.

Practically, there are real questions whether cramdown, once enacted, could operate effectively. By promoting Chapter 13 bankruptcies, cramdown will flood the courts with new bankruptcy applications. This increased workload will delay the bankruptcy process, thereby delaying any relief for consumers. In the meantime, financial institutions will see an immediate hit in their financial positions.